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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

June 29, 1998

VIA HAND DELIVERY

Magalie Roman Salas, Esq.
Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Re: *Ex Parte* - CC Docket No. 97-211
Application of WorldCom, Inc. and MCI Communications Corporation

Dear Ms. Salas:

Enclosed on behalf of WorldCom, Inc. and MCI Communications Corporation for inclusion in the above-referenced docket and in response to the request of the Staff of the Common Carrier Bureau are two (2) copies of the Affidavit of Drs. Dennis W. Carlton and Hal S. Sider filed as Attachment B to the Reply of WorldCom and MCI in Case No. 97-C-1804 before the New York Public Service Commission.

We would appreciate it if you would please date-stamp the enclosed extra copy of this filing to acknowledge receipt by the Commission.

Very truly yours,

Jean L. Kiddoo
Michael W. Fleming

Enclosures
cc: Michelle Carey (CCB)
Bill Bailey (CCB)
Michael Kende (CCB)
Marilyn Simon (OPP)

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AFFIDAVIT OF DENNIS W. CARLTON AND HAL S. SIDER

February 16, 1998

1. We are the authors of the declaration submitted to the Federal Communications Commission on January 25, 1997 on behalf of WorldCom and MCI. That declaration evaluates competitive conditions in the provision of local exchange service, long distance service and Internet services and assesses the likelihood that the proposed merger between WorldCom and MCI will adversely affect competition in the provision of these services. Based on our analysis, we concluded (at ¶4): (i) that the proposed transaction creates potentially large benefits to consumers; and (ii) that it is highly unlikely that the proposed transaction will adversely affect competition in light of the rapid entry, expansion and technological changes now taking place in the telecommunications industry.

2. We have been asked by counsel for WorldCom and MCI to evaluate and to respond to the Affidavit submitted by Robert G. Harris on behalf of GTE Corporation on February 5, 1997 to the New York State Public Service Commission. Prof. Harris claims that "the proposed merger is likely to harm New York consumers." This declaration presents a preliminary response to several of the major claims made by Prof. Harris. While it is not possible to evaluate all such claims in the brief time available for a reply, our review indicates that Prof. Harris has misinterpreted and mischaracterized several key characteristics of the telecommunications industry that relate to the potential impact of the proposed transaction on competition.

3. Our accompanying FCC Declaration addresses many of these issues in some detail. Other claims made by Prof. Harris, particularly those relating to interexchange pricing, are addressed in the Declaration of Robert Hall filed before the FCC on behalf of WorldCom and MCI on January 25, 1997 and are not addressed below. This affidavit, however, highlights only a few of the major problems in Prof. Harris' analysis, including his claims regarding: (i) barriers to entry and expansion; (ii) the competitive significance of new entrants; (iii) the significance of AT&T in the wholesale long distance industry; (iv) the effect

of the merger on National Access Points; and (v) recent increases in the stock prices of telecommunications firms. As we explain below, even these few problems show that Prof. Harris' analysis does not support his conclusions. We also present some additional comments on other aspects of Prof. Harris' analysis.[1]

BARRIERS TO ENTRY AND EXPANSION

4. Prof. Harris claims (p. 10) that "the supply of interexchange services is characterized by substantial barriers to entry. The first significant barrier to entry is the need for substantial capital and human resources outlay to provide the services and features that customers demand."

5. This statement reflects a misunderstanding of the concept of entry barriers and is contradicted by the massive entry and expansion in capacity now occurring throughout the telecommunications industry. Barriers to entry are usually defined as a cost that must be incurred by a new entrant that incumbents do not (or have not had to) bear. This widely-accepted definition, generally credited to George Stigler, means that barriers to entry do not necessarily exist just because entry is costly.[2] The fact that entry into an industry is "expensive" does <u>not</u> imply that it is likely that the industry suffers from competitive problems and above-competitive prices. Access to capital markets ensures that even high entry costs cannot prevent the entry that precludes supracompetitive pricing.

6. The massive entry now occurring into the provision of various telecommunication services is documented in our FCC declaration. This includes the construction of nationwide, high capacity fiber optic networks by Qwest, IXC, Williams Co., and Level 3 as

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1. Our failure to address below other claims made by Prof. Harris does not suggest that we agree with Prof. Harris' analysis or his interpretation of available data. Instead, it merely reflects our desire to focus on a few of the main shortcomings of Prof. Harris' analysis in the short time available to us to prepare a response.

2. See the discussion of entry barriers in Carlton's textbook (with J. Perloff), <u>Modern Industrial Organization</u>, p. 110. Stigler discusses this general definition in his book <u>The Organization of Industry</u> (1968).

well as more limited entry by others. These major entrants are all highly credible, and are well-financed and managed by individuals with significant industry experience. These new networks generally contain more fiber capacity and more sophisticated electronics than the networks now in place. In addition, significant portions of the Qwest and IXC networks have been sold to major telecommunications firms such as GTE and Frontier that will independently own, operate and market the capacity they own.

7. News reports in the few weeks since our declaration has been filed provide additional examples of entry and expansion. AT&T, for example, recently announced that it will use new technology from Lucent to double the capacity of its network by the end of 1998[3] and to increase its capacity "by a factor of 10 over the next few years."[4] Williams Co., which previously announced an investment of $2.7 billion for construction of a 32,000 route-mile national fiber optic network, recently announced plans to accelerate the deployment of its network.[5]

THE COMPETITIVE EFFECTIVENESS OF ENTRANTS AND SMALLER NETWORKS

8. Prof. Harris' claim that the merger of WorldCom and MCI will adversely affect competition in the provision of wholesale long distance services rests on his view that "[c]arriers with regional or limited networks cannot provide adequate competition to check the anticompetitive effects of the proposed merger." To support this claim, Prof. Harris cites data on the geographic coverage for entrants into long distance services and the fact that they now have fewer points of presence (POPs) than the largest national networks, AT&T, MCI and Sprint.

9. Prof. Harris' suggestion that networks smaller than AT&T, MCI and Sprint

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3. Wall St. Journal, January 27, 1998, p. B6.

4. New York Times, January 27, 1998, Section D, p. 1.

5. PR Newswire, Williams press release, February 11, 1998.

"cannot provide adequate competition" is at odds with his own analysis of the importance of the competitive significance of WorldCom. Prof. Harris notes that even today WorldCom has many fewer POPs than AT&T, MCI and Sprint, and that WorldCom served far fewer POPs as recently as 1996. For example, Exhibit 6B to Prof. Harris' affidavit shows that WorldCom has 162 POPs today, while Sprint has 399, MCI has 582 and AT&T has 715. Prof. Harris' Exhibit 13 shows that as recently as 1996, WorldCom had only 110 POPs.

10. Nonetheless, Prof. Harris emphasizes throughout his report that WorldCom has played a significant role in promoting competition in the industry. For example, he claims that, "[a]cting as the industry 'maverick,' WorldCom has helped spur the growth of the [interexchange] resale segment and the concomitant check on anticompetitive behavior by the Big Three." (p. 7) Prof. Harris cannot have it both ways. Clearly, networks like WorldCom's that are smaller than those of AT&T, MCI, and Sprint can significantly affect competition. Thus, there is every reason to think that the large and sophisticated entrants now investing billions in deploying new networks also will be effective competitors.

11. Prof. Harris also emphasizes GTE's reliance on WorldCom in providing wholesale services and that other network providers cannot provide comparable service. He states that "GTE must be able to maintain a strong relationship with a national facilities-based interexchange carrier. WorldCom is exactly that carrier."

12. Again, this claim is inconsistent with Prof. Harris' assertion that networks without the geographic coverage of AT&T, MCI and Sprint cannot be effective competitors. Moreover, this claim is not supported by the experience of other resellers. For example, Excel, perhaps the nation's largest reseller, relies extensively on "second tier" providers of wholesale service. Until 1996, Excel purchased much of its transmission from Frontier. At that time, Excel entered into a contract with IXC, which now carries a substantial portion of Excel's traffic, and uses other carriers as well.[6] This suggests, contrary to Prof. Harris'

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6. Excel Communications, Form 10-K for December 31, 1996; IXC 10-K, December 31, 1996.

assertion, that resellers can be sophisticated buyers that can assemble the necessary geographic coverage by relying on smaller networks.

13. Finally, Prof. Harris mischaracterizes the scope and coverage of new networks and the speed with which they can expand. He claims, for example, that Qwest and IXC "have relatively few points-of-presence" and that "Qwest's own network reaches from San Francisco to Columbus, OH." (p. 7) The data he reports, however, indicate that Qwest already has more than 100 POPs and that IXC has in excess of 75. (As noted above, Prof. Harris' data indicate that WorldCom today has 162 and as recently as 1996 had only 110.) Moreover, construction of the Qwest and IXC networks is not complete. Deployment of Qwest's nationwide network is expected to be completed in the second quarter of 1999 and deployment of IXC's nationwide network is expected to be completed by the end of next year. Thus, Prof. Harris' data suggest that these entrants already have a significant competitive presence and that their competitive significance will increase in the near future.

AT&T'S ROLE IN THE PROVISION OF WHOLESALE SERVICE

14. Prof. Harris claims that "the proposed merger would have a disproportionate effect on the resale segment of the interexchange market. Importantly, AT&T does not compete to a great extent in resale segments, which reduces effective supply for resellers from three carriers to two." (p. 19) Prof. Harris' claim is based on data from a February 1996 study from Atlantic-ACM, a firm that publishes research on the telecommunications industry.

15. First, the 1996 data cited by Prof. Harris report AT&T had a 12 percent share of services sold to resellers that do not own switches. This figure was based on a survey of various resellers and was constructed using unweighted averages of the purchasing shares of the surveyed resellers that do not own switches. The more appropriate revenue-weighted share for AT&T was 37 percent.[7] Indeed, Atlantic-ACM noted in the report cited by Prof.

7. Consider a simple example in which Reseller 1 purchases all its wholesale capacity (continued...)

Harris that a revenue-weighted figure (not an unweighted figure like that used by Prof. Harris), "more accurately depicts the wholesale usage . . ." Thus, the 1996 survey cited by Prof. Harris indicates that AT&T played a significant role in serving this group of customers.

16. Atlantic-ACM presented more recent estimates of AT&T's role in the wholesale marketplace in a 1997 report.[8] This survey reports AT&T's revenue-weighed share for (i) private line (e.g., transport-only) services; (ii) switched services (in which AT&T and others provide both transport and switching).[9] These more recent Atlantic-ACM data indicate that AT&T accounted for 38 percent of private line sales, indicating that, contrary to Prof. Harris' claim, AT&T plays a significant role in providing this type of wholesale capacity. With respect to the provision of switched services, the Atlantic-ACM data indicate that AT&T is among a large number of wholesale suppliers. These figures indicate that firms other than AT&T, Sprint, MCI and WorldCom account for nearly 40 percent of such sales. Again, Prof. Harris' claim that the proposed transaction "reduces effective supply for resellers from three carriers to two" is not supported by the data.

17. More fundamentally, however, Prof. Harris' claim that AT&T is not a significant participant in reselling wholesale capacity is inexplicable given the fact that MCI, Sprint, and WorldCom each grew up reselling AT&T capacity. Ironically, Prof. Harris emphasizes this

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7.(...continued)
from AT&T, while the remaining 99 resellers each purchase all their capacity from MCI. Prof. Harris would calculate AT&T's share as the unweighted average of 1 percent (=100/100). Such an unweighted average will not accurately reflect AT&T's importance if all resellers are not equal in size. For example, suppose that Reseller 1 has $1 billion in sales while Resellers 2 through 100 sell virtually nothing. In such a case, AT&T's share should be based on the revenue-weighted average and would approach 100 percent.

8. Atlantic-ACM 1997-98 Interexchange Services Market Sizing and Share Analysis, July 1997.

9. These categories do not correspond precisely to those used in Atlantic-ACM's 1996 report. We understand that much of private line services are purchased by facilities-based resellers (that provide, at least in part, their own switching); switched wholesale services are purchased by resellers that do not perform any of their own switching and by facilities-based carriers for areas in which they do not have switches.

precise history in another section of his affidavit, where he states that "[w]hen MCI and Sprint first entered, they supplemented their own facilities with resold AT&T service in order to offer national coverage. Similarly, WorldCom was first a reseller ..."

NATIONAL ACCESS POINTS AND INTERNET

18. Prof. Harris stresses that "WorldCom-MCI's ability to exercise horizontal market power for backbone service is exacerbated because it controls five of the twelve public interconnection facilities . . ." What Prof. Harris fails to mention, however, is that the transaction will have no effect on the concentration in ownership of these facilities because MCI controls none of them. (See Harris Exhibit 16.) Moreover, Prof. Harris offers no logical theory explaining how or why WorldCom would be able to use these public interconnection points to "degrade the quality of rivals' network performance" given the availability of alternative types of interconnection, and the absence of barriers to the establishment of new public interconnection points. For example, in 1995 there were only four NAPs;[10] today there are about 40 or so in the United States.[11] More generally, the spectacular growth in Internet services in the past few years provides dramatic evidence that there are few if any barriers to the entry and expansion of firms in the provision of Internet services.

STOCK MARKET PERFORMANCE

19. Prof. Harris notes that "the stock market valuation of both the merging parties and their facilities-based competitors have rocketed between the time of the announcement and the present date . . . suggesting that [the merger] is highly anticompetitive." Such a conclusion cannot be based on the stock market evidence presented by Prof. Harris. It is

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10. Boardwatch Magazine Directory of Internet Service Providers, Summer 1996, pp. 10-11.

11. Information Sciences Institute of the University of Southern California. (http://www.isi.edu/div7/ra/NAPs/naps_na.html)

simply impossible to attribute stock market performance over a period of several months to one event; here, the alleged anticompetitive effects of this transaction. A large number of factors contribute to stock market performance over such an extended period. Indeed, it is standard practice in the finance literature to look at much shorter time horizons (at most a few days) to isolate the effect of some event. (Such studies are called "event" studies.)

20. Our analysis of the history of stock price changes for AT&T on a daily basis over recent months illustrates the fallibility of Prof. Harris' analysis.[12] Using standard methods of analysis for event studies, our analysis shows that AT&T's stock price fell relative to the market on October 1-2, the two days following the announcement of the proposed WorldCom/MCI merger. This result is inconsistent with Prof. Harris' claim. Instead, other factors appear to account for the increase in AT&T's stock price over the last few months. For example, AT&T's stock price increased (on a net-of-market basis) by roughly 13 percent in the days surrounding its announcement of a new Chief Executive Officer on October 20. Similarly, AT&T's stock price rose 8 percent following reports on November 18 that a cost-cutting plan would be implemented. In sum, a closer examination of the stock market performance of industry leader AT&T fails to support Prof. Harris' claim that the alleged anticompetitive effects of the proposed transaction caused AT&T's share price to rise over this period.

FINAL COMMENTS

21. Three brief final points regarding Prof. Harris' analysis are worthy of note:

- Prof. Harris acknowledges that a merger between interexchange providers and entrants into local service can generate significant economies of scope. (p. 11) As emphasized in our prior declaration, these are precisely the type of efficiencies that are likely to be realized as the result of the combination of

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12. AT&T's market capitalization exceeds the sum of that for all other firms considered by Prof. Harris.

MCI's interexchange service with WorldCom's local services.

- Prof. Harris does not claim that the proposed transaction will adversely affect competition in the provision of local services.
- While Prof. Harris stresses GTE's role as a reseller (and its reliance on WorldCom as a supplier of wholesale capacity), he fails to discuss in any detail GTE's entry as a network operator through acquisition of a substantial portion of capacity throughout the Qwest Network. As noted in our earlier declaration, current GTE advertisements herald its new role as a national supplier of network services.

Dennis W. Carlton

Hal S. Sider

Subscribed and sworn to before me,
this 16th day of February, 1998.

Notary Public

My Commission expires: 7-26-99

"OFFICIAL SEAL"
MARGARET J. KUSH
Notary Public, State of Illinois
My Commission Expires 7-26-99